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ABSTRACT

Information on direct and indirect costs of federally-sponsored research at colleges and universities, the nature of such costs, and the necessity of such costs are presented in this booklet that summarizes relevant federal regulations itemized in Office of Management and Budget Circular A-21, which deals wholly with the costs of research and other sponsored projects. According to Circular A-21, allowable costs under federally sponsored research agreements include all expenses that have been incurred solely for work on the project (direct costs), and a share of other costs that are incurred primarily for necessary administrative and service functions related to the sponsored research projects (indirect costs). Direct costs usually include: salaries and wages, personnel benefits, supplies, travel and communication, equipment, computer use, and alterations and renovations. Indirect costs are usually divided into the following categories of supporting activities: general administration and general expense, sponsored project administration, plant operation and maintenance, library expenses, departmental administration expenses, depreciation or use allowance, and student administration and services. The rate for reimbursement of indirect costs is calculated according to the procedures set forth in OMB Circular A-21. When all the calculations have been made, the institution prepares an annual indirect cost proposal and submits its working papers and supporting data to the federal audit agency for review. Costs that may be classified as either direct or indirect are listed, and institutional organization that may affect the indirect cost rate are described. (SW)

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Since World War II, colleges and universities in the United States have become deeply involved in research sponsored by the federal government. The total cost of such research, borne jointly by government and the educational institutions, has two components: direct and indirect costs. Direct costs are generally understood because these costs are clearly identifiable and related to specific projects. Indirect costs are elusive. They are often not readily understood because they relate to general institutional activities that support research but do not serve research uniquely; however, they are essential to the performance of research.

The purpose of this booklet is to give a general overview of direct and indirect costs, the nature of such costs, and the necessity of such costs.

This brochure was originally published by the American Council on Education in 1969. It has been substantially revised for this edition.

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Direct and Indirect Costs of Research at Colleges and Universities

The operation of any enterprise involves costs that pertain to a specific project, as well as general costs. For administrative and accounting purposes, these costs are grouped into two categories—direct and indirect. Many costs, however, are not discretely direct or indirect, and may appear in either category, depending on the circumstances. Such is the case with costs of federally sponsored research at colleges and universities.

The basic regulations for ascertaining the costs of federally sponsored research at educational institutions are set forth in Office of Management and Budget (OMB) Circular A-21. This document is designed to provide a governmentwide approach to determining such costs in the performance of research under federally sponsored projects.

In any consideration of the importance of indirect costs and their relationship to the performance of sponsored research, six points must be clearly understood at the outset:

1. Indirect costs are real costs that provide reimbursements for certain expenses incurred in conducting or supporting research. Funds paid to an institution for indirect costs of a sponsored project are reimbursement to the institution for expenditures already made.
2. The indirect cost rate is established by negotiation with the cognizant federal agency¹ on the basis of costs incurred by the

¹ OMB Circular A-88 designates the cognizant agency and establishes policies whereby that federal agency (cognizant agency) will act for all federal agencies in auditing educational institutions, negotiating indirect cost rates, and resolving audits.

institution in a previous year and distributed as prescribed in government regulations as set out in OMB Circular A-21.

3. The institution's rate proposal for indirect costs is audited by federal auditors before negotiation of indirect cost rates.
4. Depending on how an institution organizes for the management of its research, some costs may be considered either direct or indirect *but not both*.
5. Differences in institutional organization for the management of research are a principal reason for the differences in indirect cost rates among institutions.
6. Although indirect cost rates vary among institutions, the variance is unrelated to whether an institution is publicly or privately controlled.

Indirect Costs Are Real Costs.

In undertaking any research project, whether or not it is sponsored by the federal government or by some other organization, an educational institution must cover two components of costs—those directly attributable to the specific project and those incurred for the general support and management of research. General support and management costs are sometimes referred to as "pooled costs" because they are accounted for and controlled centrally. Examples are library costs, utility costs, the costs of operating and maintaining the plant, and costs of the general administrative organization of the institution.

The classification of particular expenditures as direct or indirect costs depends in part on the institution's organization for managing its business affairs and its methods of managing research. The two classes of expenditures, however, are equally necessary to achieve the research objectives, and each type of cost is as true a cost as the other. The institution becomes committed to incurring costs in both categories when it assumes stewardship of a sponsored research project.

Both direct costs and indirect costs are real costs and are generally incurred before the institution is reimbursed. If the sponsors of research projects do not fully reimburse either the direct or indirect costs, these costs must be paid from other institutional funds, such as instruction and departmental research funds. As a result, these programs are often short-changed.

OMB Circular A-21, first published in 1958, was a consequence of the federal government's desire to improve the methods of determining costs for federally sponsored research. The circular followed closely the principles that several agencies had already set for determining the costs of sponsored research at educational institutions. The circular was developed by the Bureau of the Budget (now OMB) with the active participation of federal agencies sponsoring research and after consultation with representatives of educational institutions. It has been amended from time to time when experience showed the need for clarification. The most recent amendments were issued in March 1979.

OMB Circular A-21 deals wholly with the costs of research and other sponsored projects. Its terms clearly exclude any provision for profit or other increment above cost and certain types of expenditures that OMB classifies as "unallowable." According to OMB Circular A-21, allowable costs under federally sponsored research agreements include (1) all expenses that have been incurred solely for work on the project (direct costs); and (2) a share of other costs that are incurred primarily for necessary administrative and service functions related to the sponsored research project (indirect costs). When these two classes of expenditures have been determined, using the principles set forth in OMB Circular A-21, they must be added to obtain the total costs of the research project.

DIRECT COSTS usually include costs of the following types:

- *Salaries and wages*—salaries and wages of persons employed on the research project
- *Personnel benefits*—personnel fringe benefits, such as FICA and retirement plan contributions (in some situations, these are categorized as indirect costs)
- *Supplies*—consumable supplies needed for the project
- *Travel and communication*—all such charges incurred for the project
- *Equipment*—usually the costs of equipment acquired for specific use in the research project
- *Computer use*—computer time and necessary supporting services, calculated in accordance with an approved rate schedule for the facility concerned
- *Alterations and renovations*—costs of alterations and renovations as determined by specific agreements

INDIRECT COSTS, on the other hand, are usually divided into the following categories of supporting activities:

- *General administration and general expense*—accounting, payroll, administrative offices, and so forth
- *Sponsored project administration*—personnel and other costs of offices whose responsibility is the administration of sponsored projects
- *Plant operation and maintenance*—utilities, janitorial services, routine maintenance and repairs, and so forth
- *Library expenses*—books, library staff, and so forth
- *Departmental administration expenses*—administrative costs at the college and departmental levels
- *Depreciation or use allowance*—for buildings and equipment, excluding buildings and equipment paid for by the federal government
- *Student administration and services*—deans of students; admissions offices; and registrars' offices

Indirect Cost Rates Are Calculated According to Federal Guidelines.

The rate for reimbursement of indirect costs is calculated according to the procedures set forth in OMB Circular A-21. The first step is to ascertain the total expense incurred by the institution for the operation of all its administrative and central or supporting service activities described here as indirect costs. The computation of this figure involves analysis of the institution's financial data in order to calculate the total amount of indirect costs incurred by all programs of the institution, including sponsored research and other organized research.

The next step is to distribute the total amount of institutional indirect costs among the four basic functions of the institution. These functions are defined in OMB Circular A-21 as (1) instruction, including departmental research; (2) organized research (the major portion of which is likely to be federal sponsored research); (3) other sponsored activities; and (4) other institutional activities.

For example, an institution may distribute its costs of plant operation and maintenance among the four functions in proportion to the amount of space occupied by each or in proportion to the amount of salaries and wages incurred by each where space is used jointly. This distribution establishes total costs attributable to the four functions.

The final step is to establish the actual indirect cost rate as a percentage of an appropriate base. In accordance with OMB Circular A-21, the normal practice is to use modified total direct costs as the base. For example, the organized research rate is determined by calculating the ratio of indirect costs of organized research to the base. This ratio, expressed as a percentage of the base, is then applied to each sponsored project at the institution to determine the portion of the indirect costs to be recovered.

Equity may require that an institution have more than one indirect cost rate. A separate calculation may be made, for instance, for a medical school or for projects conducted at remote locations. When separate rates are required, each is calculated in accordance with the procedures established by OMB Circular A-21, using costs attributable to the separate location or organizational unit.

Indirect Cost Rates Are Audited by Federal Auditors.

Colleges and universities do not themselves determine the ultimate costs of research projects. All such costs are subject to audit by the federal government. When all the calculations discussed have been made, the institution prepares an annual indirect cost proposal as described and submits its working papers and supporting data to the institution's federal audit agency for review. After the federal audit agency carefully examines and audits all costs, disagreement about allowable indirect costs or the resulting indirect cost rate is settled by negotiations between the institution and representatives of the agency. The government and the institution then reach an agreement on the indirect cost rate for the year under discussion.

Some Costs May Be Classified Either as Direct or as Indirect.

The way in which an institution organizes its business and administrative affairs has a direct bearing on whether costs fall within the direct or the indirect cost category. Examples of costs that may be treated

either as direct or as indirect costs, depending on institutional management procedures, are listed below:

- secretarial support
- administrative and clerical personnel
- purchasing
- Social Security, retirement contributions, and group insurance
- vacations, holidays, and sick leave
- hospitalization and medical services
- postage and communications (both local and long distance)
- stationery and office supplies
- stockroom personnel
- books and periodicals
- janitorial services
- security expenses
- liability insurance, workmen's compensation
- utility costs

For example, one institution may assign secretaries directly to research projects and thereby be able to recover their salaries as direct costs. Another institution may decide that secretarial time will be more efficiently used if departmental secretarial pools are maintained, with projects drawing upon the departmental pool when they need such services. In an institution with departmental pools, secretarial costs could be recovered as part of the indirect costs. In addition, some institutions are so organized that certain other supporting services are commonly made available to research programs as well as to academic departments, because centralization is believed to effect the best use of supporting staff. Thus, the method of organization materially influences the indirect cost rate.

Institutional Organization Affects the Indirect Cost Rate.

Variations in institutional organization and accounting practices are largely responsible for differences in indirect cost rates. On average, this variation makes no difference in the total cost, since both types of costs are real and are actually incurred. Under current regulations, an institution classifying more items as direct costs may

recover a somewhat larger amount from the sponsor, because institutions are not reimbursed for all indirect costs. The total cost of research remains unchanged by transferring secretarial salaries or telephone costs from the indirect cost classification to the direct cost classification or vice versa. Such a transfer will lower the indirect cost rate of a project but raise the direct cost. This increase in direct cost can be significant in instances where costs were formerly spread over an indirect cost pool but are now confined to benefiting projects.

Federal auditors make a careful review to ensure that any item or expense or any class of items is treated consistently at any given institution (or major institutional component where a separate rate is computed) as either direct or indirect cost and that no item appears in both categories. All colleges and universities calculate their indirect cost rates in accordance with OMB Circular A-21. Although rates differ among individual institutions, most of the differences are due to the differing organizational and accounting approaches previously discussed.

For the reasons given here, an indirect cost rate itself has little meaning. The percentage must be interpreted in terms of the base on which it is calculated and with reference to the allocation (between the direct and indirect categories) of costs incurred by the institution. It is illogical to compare indirect cost rates among institutions or to draw inferences concerning the reasonableness of indirect cost reimbursement on the basis of the rate alone. □